Testimony of Robert S. McIntyre
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Before the Committee on the Budget
United States House of Representatives
Concerning "Waste, Fraud, [and] Abuse in Federal Mandatory Programs"
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Recent projections from the Congressional Budget Office indicate that in fiscal 2003, the on-budget federal deficit is likely to exceed $570 billion. That means that one out of every three dollars that the federal government spends outside of the self-funded Social Security system will be paid for by borrowing. This will be the highest share of on-budget federal spending financed by deficits since World War II.

Faced with this dire fiscal situation, which shows no sign of abating in the future, it is entirely appropriate that this Committee is searching for ways to stem the torrent of red ink.

In seeking to reduce the enormous rise in federal borrowing, however, one important area has been largely off the radar screen of the majority party in Congress: the many mandatory federal programs embedded in the tax code and administered by the Internal Revenue Service.

As the Joint Committee on Taxation points out:

> "Special income tax provisions . . . may be considered to be analogous to direct outlay programs, and . . . are similar to those direct spending programs that are available as entitlements to those who meet the statutory criteria established for the programs."
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> Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years 2003-2007*, Dec. 19, 2002

The Joint Committee on Taxation's most recent compilation of these tax-code-based spending programs, issued last December, found a total of $843 billion in such programs in this fiscal year alone, rising to $915 billion by fiscal 2007. That's more than the total amount of discretionary appropriations.

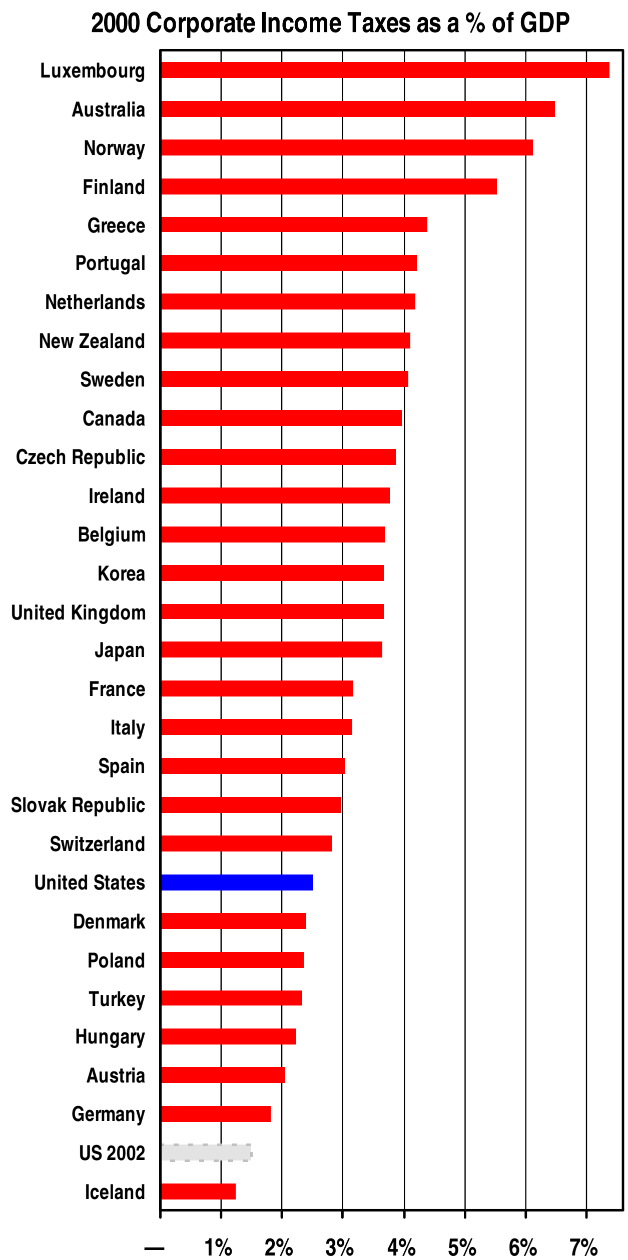
It should be noted that even these enormous figures for tax-based spending are substantially understated. They do not include the recently-enacted increases in tax-based spending in the 2003 tax bill. They assume that various sunsets on old and new tax-based spending programs will be honored. They use a statistical trick to greatly understate the tax code's largest official corporate tax subsidy, accelerated depreciation. And they do not include the huge and growing cost of the burgeoning abusive corporate tax shelters that Congress and the Bush administration have so far chosen to encourage or at least tolerate.

To be sure, some tax-based spending programs serve important needs that would doubtless incur significant federal costs if they were run by government agencies other than the IRS. In my testimony today, I want to focus on what I see as the most objectionable and fastest growing area of wasteful tax-based spending programs, those that are designed to subsidize various corporate activities. There are more than 75 of these "mandatory" corporate subsidy programs, benefitting activities such as oil drilling, insurance, nuclear power, commercial real estate, equipment purchases, drug manufacturing, ethanol production and so on.

In President Reagan's second term, he strongly criticized corporate tax subsidies as wasteful, inconsistent with free-market principles and harmful to economic growth. At Reagan's instigation, the subsidies were sharply cut back in 1986. But in recent years, corporate tax subsidies have made a striking comeback, and are now costing ordinary taxpayers close to

$200 billion annually. They should be prime targets for reexamination in the effort to bring the budget back into balance.

Our low, low corporate taxes—and high, high corporate tax subsidies



Contrary to the constant whining that members of Congress hear from corporate lobbyists, corporate income taxes in the United States have fallen so much over the past few decades that they now are virtually the lowest among the world's developed countries. Here are a few salient facts, taken from the Organisation for Economic Co-operation and Development's October 2002 comparison of taxes among its member countries:

- In 1965, U.S. federal, state and local corporate income taxes were 4.1 percent of our gross domestic product, compared to 2.4 percent of GDP in the other OECD countries.
- But by 2000, U.S. corporate income taxes had dropped to 2.5 percent of GDP, while corporate income taxes in the other OECD countries had risen to 3.4 percent of GDP. That placed us 22nd among the 29 reporting OECD countries.
- In 2002, the last year for which full federal, state and local figures are available, U.S. corporate taxes plummeted to only 1.5 percent of our GDP. That's below the most recently reported corporate tax levels in any other OECD country except Iceland.
- Looking only at the U.S. federal tax system, corporate income taxes have fallen to only 1.2 percent of the GDP this year and last—69 percent below their 3.8 percent share of GDP in the 1960s.

This sharp drop in corporate tax payments in the United States in recent years has not been caused by a lower statutory corporate tax rate, but rather by an explosion in congressionally-enacted tax subsidies and a wave of corporate tax-sheltering activity. As a result, most of the profits that corporations report to their shareholders are never reported on their tax returns. In fact, it appears that this year corporate taxes as a percent of U.S. profits will fall to well under 15 percent—probably only about a third of the statutory corporate rate of 35 percent.

Recent legislation has vastly expanded tax-based corporate subsidies

In early 2002, Congress enacted the largest corporate tax reduction in a generation, primarily by greatly expanding the amount that companies can write off for wear and tear on their equipment. This $114 billion expansion in business tax subsidies was defended as a supposed "stimulus" to our ailing economy, and was supposed to "sunset" in the fall of 2004, then to be followed by partially offsetting big corporate tax increases in future years. But last month, the 2002 "depreciation" tax subsidies were extended and increased (and the bill initially passed by the House would have provided an even longer extension).

The combination of the 2002 and 2003 corporate tax changes is expected to increase business tax subsidies by a total of $178 billion in fiscal 2002-2004. For corporations, that will cut income tax payments by 25 percent over that period. And if the revised "sunset" date is waived after the end next year, then the cost of these programs will exceed $400 billion over a decade.

Under current depreciation rules, the profits generated by equipment investments often aren't taxed at all. Instead, many investments enjoy "negative" tax rates, that is, they are more profitable after tax than before. A whole industry has risen up to help companies with excess tax subsidies to sell the excess to other companies, typically through leveraged leasing deals, thereby making the tax subsidies essentially "refundable."

On its face, the asserted purpose of the recent corporate "stimulus" bills seems sadly misdirected. For the past few years, our economy has faced serious excess capacity: businesses can make more products than consumers want to buy. Oddly, Congress and President Bush concluded that rather than trying to boost demand, the answer to the over-capacity problem was to try to encourage even more over-capacity. Not surprisingly, this nonsensical strategy hasn't worked. By the end of 2002 the Business Roundtable reported that more than 80 percent of its members planned no added investment—although they were surely happy to take the money for doing what they would have done anyway.

Yet confronted with the abject failure of the previous effort at economic stimulus, Congress and the President have not admitted their mistake. Instead, they concluded that throwing good money after bad was the best policy and included even bigger corporate depreciation subsidies in the 2003 tax bill.

Offshore corporate tax-sheltering schemes have pushed corporate subsidies still higher

The fact that Congress was so eager to extend its obviously failed corporate "stimulus" program illustrates just how hard it is to eliminate tax-based spending programs once they are placed in the tax code. But while the justification for the recent corporate "stimulus" legislation is shaky in the extreme, Congress's tolerance of the wave of abusive offshore corporate tax shelters that have emerged in recent years is even worse.

By way of background, the traditional goal of U.S. corporate tax policy is to tax companies—whether American or foreign-owned—on the profits that they earn in the United States. We give a full tax credit for taxes paid on profits earned abroad, that is, *actually* earned abroad. For their part, corporations try very hard to make their U.S. profits appear to be foreign on paper, in order to avoid paying taxes to any country. In recent years, major accounting firms have designed an array of abusive tax shelters that have hugely expanded such paper profit shifting.

Everyone has heard about the dozens of American companies that have chosen to renounce their American citizenship and reincorporate in Bermuda or other tax haven countries to avoid paying taxes on their U.S. profits. In the face of public outrage, only a few politicians are willing to publicly defend this unpatriotic practice.

But the Bermuda tax-avoidance scheme is only the tip of a vast iceberg of corporate offshore tax sheltering—all designed to shift U.S. profits, on paper, outside the United States. Congress and the President have failed to act to curb these abuses, which all together are costing the Treasury and ordinary taxpayers on the order of $50 billion or more a year.

Earlier this year, the Senate version of the 2003 tax cut bill proposed to take a few small steps toward curbing the Bermuda loophole, "Enron-style abuses," and other indefensible corporate tax-shelter subsidies. But even these modest changes were rejected out of hand by the House.

In fact, the Chairman of the Ways and Means Committee has made it clear that he favors a vast expansion in subsidies for offshore tax sheltering. Last year in H.R. 5095, he proposed $83 billion in additional subsidies to encourage offshore tax avoidance, only slightly offset by the $14 billion in temporary tax-shelters curbs he felt forced to propose in response to public outrage over the Bermuda loophole.

Of course, some may argue that there should be no taxes on corporate profits, or on any kind of investment income for that matter, and that only wages should be taxed. That indeed is the apparent opinion of the Bush Treasury Department, along with many antitax groups and some members of Congress. But even if one has that goal—totally mistaken in my view—setting up a tax system that encourages avoidance and evasion by the unscrupulous at the expense of honest corporate and individual taxpayers is indefensible.

Curbing corporate entitlements

The agenda for corporate entitlement reductions is a long one. Let me quickly highlight a few areas that ought to be given a very hard look:

- ***Excess depreciation write-offs.*** Beyond enforcing the sunsets on the 2002 and 2003 misdirected "stimulus" bills, Congress could go considerably further in curbing unwise depreciation tax subsidies. If our goal is to tax corporations on what they really earn, then tax deductions for depreciation ought to be based on a reasonable approximation of actual wear and tear, not used as a hidden subsidy that distorts investment behavior and interferes with fair competition. In addition, depreciation write-offs on debt-financed investments could be disallowed, either completely or at least partially, as the corporate alternative minimum tax used to do before it was gutted in the 1990s.

- ***Multinational tax subsidies.*** There are many steps that could be taken to curb our current array of wasteful, if not perverse, tax subsidies for multinational corporations. For one thing, we don't have to let a mail drop in Bermuda turn an American company into a foreign corporation. Instead, Congress could follow the lead of countries such as Germany, Japan, and the United Kingdom, and treat any ostensibly "foreign" corporation whose shares are mostly owned by Americans as American.

  Going beyond the specific Bermuda loophole, we could take on offshore corporate tax sheltering generally. One important step would be to scrap an antiquated rule that lets U.S. companies indefinitely "defer" reporting their foreign profits on their U.S. tax returns. As noted above, it's not that we want to tax actual foreign earnings: We give companies a full tax credit for the taxes they pay to foreign governments when and if they report the foreign income to the IRS. But deferral opens up the door to other scams that companies use to shift their American profits on paper to tax-haven countries, and our current anti-abuse rules are too weak. Eliminating deferral would stem these abuses and hugely simplify the corporate-tax laws to boot. That's exactly what the Kennedy administration unsuccessfully proposed back in the early 1960s, and what both the House and the Senate passed in the mid-1970s—unfortunately not at the same time.

Congress could also consider scrapping our unworkable rules that require the IRS to examine billions of fictitious intracompany transactions, and instead adopt a combined-reporting system that allocates taxable corporate profits among countries based on a straightforward formula. Under this approach, a corporate tax would apply once and only once, rather than only occasionally as is too often the case under current law.

- ***Industry-specific subsidies.*** Using the tax code to favor particular industries and/or investments that make no economic sense in the absence of a subsidy (such as ethanol) is almost always bad policy. As part of corporate entitlement reform, Congress should consider clearing out the array of narrow-interest business subsidies that were they not hidden in the tax code, would have stood almost no chance of being enacted in the first place.

Conclusion: Eliminate the Double Standard

This year, on-budget federal revenues are expected to fall to about 11½ percent of GDP, the lowest level since before World War II, and about a quarter below the 15.9 percent level in fiscal 2000. This drop explains most of the enormous deficits we face this year and in the future. Of course, the recently enacted reductions in personal tax rates and the phase-out of the estate tax explain much of this decline. But the vast expansion in tax-based subsidy programs, particularly the hundreds of billions of dollars annually for corporations, looms very large as well.

Despite artificial bookkeeping differences, it seems obvious that programs should be evaluated on the same terms whether they are run by a regular government agency or by the IRS through the tax code. To do otherwise would elevate form over substance, and make responsible budgeting difficult or impossible.

So if this Committee is seriously interested in reducing our government's unsustainable borrowing binge, then curbing unwarranted tax-based entitlement programs, especially the many expensive tax subsidies for corporations that fail to serve any worthwhile economic or social objective, should be high on the agenda.

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